

Special Committee on Environmental Disclosure Newsletter

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July 2006

MESSAGE FROM THE CHAIR

Jeffrey A. Smith

Sometimes it's good to go wide. Sometimes you have to go deep.

In this issue of the Special Committee on Environmental Disclosure Newsletter, Scott Deatherage, our trusty editor, has taken us deep into one of the most controversial recent issues underlying environmental disclosure—the application of FAS 143/ FIN 47. To do so, he has assembled a multi-disciplinary panel of experts and has led them through some of the most elusive elements of the new rules. Their significance is obvious, because the results appear directly on the balance sheet. Several dozen public companies have reported charges in their 2006 first quarter 10Qs as the result of these new rules.

We hope that you will find the Dialogue, printed below, to be thought-provoking and informative, and that it will help you prepare for ongoing developments in this area.

**ABA Section of Environment, Energy,
and Resources**

**14th Section Fall Meeting
Oct. 4-7, 2006
San Diego, California**

DIALOGUE: DECIPHERING AND APPLYING CRITICAL TERMS UNDER FAS 143 AND FIN 47—“NORMAL OPERATIONS” AND “ASSOCIATED WITH ASSET RETIREMENT”

Scott D. Deatherage
Editor

Introduction

The Financial Accounting Standards Board's (FASB) Financial Accounting Standard (FAS) No. 143, Accounting for Asset Retirement Obligations, and its subsequent interpretation of this standard, Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations have created controversy and some confusion for corporations. The “Dialogue” contained in this newsletter addresses two issues critical to identifying potential asset retirement obligations (AROs) and conditional asset retirement obligations (CAROs); (1) to what extent environmental remediation liabilities arise from “normal operations,” and thereby are subject to further analysis under FAS 143/FIN 47, and (2) in what circumstances are obligations to address environmental contamination “associated with retirement” and, therefore, potentially reportable under FAS 143/FIN 47.

From the outset it is clear that both public and private companies should establish an appropriate process for reviewing their potential environmental liabilities to determine whether they fall within the reporting

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obligations of FAS 143/FIN 47. All companies should evaluate whether environmental obligations that do not fall under FAS 143/FIN 47 nevertheless must be accrued and/or disclosed under FAS 5, Accounting for Contingencies, or AICPA Statement of Position 96-1, Environmental Remediation Liabilities (SOP 96-1).

Brief Explanation of FAS 143/FIN 47 and the Terms “Normal Operations” and “Associated with Retirement”

Before we hear from our panelists, some background is in order.

First, of all it is important to understand the definition of an asset retirement obligation and a conditional asset retirement obligation. The FASB defined an asset retirement obligation in FAS 143 as follows:

This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. As used in this Statement, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel.

In March 2005, the FASB issued FIN 47 interpreting FAS 143 described a conditional asset retirement obligation as follows:

This Interpretation clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to

perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Thus, the timing and (or) method of settlement may be conditional on a future event. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional asset retirement obligation should be recognized when incurred—generally upon acquisition, construction, or development and (or) through the normal operation of the asset. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. Statement 143 acknowledges that in some cases, sufficient information may not be available to reasonably estimate the fair value of an asset retirement obligation.

In illustrating CAROs in FIN 47, the FASB offered four examples. The first involved replacement telephone poles that must be disposed of in a particular way because of their chemical treatment. The second involved disposal of kiln brick contaminated as part of its use. The last two involved asbestos in buildings. All of these examples relate to environmental conditions.

In applying these standards, one must determine what environmental legal obligations must be reported under FAS 143/FIN 47. First, an entity must identify the environmental conditions associated with its assets and operations. Second, the entity must determine whether these conditions constitute an ARO or CARO. Environmental conditions (*e.g.*, asbestos-containing materials, underground storage tanks, or soil and groundwater contamination) may be associated with a facility as a whole or a subcomponent of a facility. Once these conditions are identified, the next step is to determine whether each listed condition resulted from the “normal operation” of the asset. If it is determined that an environmental condition did arise from the normal operation of the asset, the entity must next determine whether there is a legal obligation associated with the environmental condition, and, if so, whether

that legal obligation is “associated with retirement of the related asset.” In our dialogue, we will focus primarily on remediation or cleanup liabilities, and to what extent these obligations fit within FAS 143/FIN 47.

While this interpretive construct seems straightforward, there is still substantial uncertainty lurking in the definitions of key operative terms—two, in particular. First, our panel will explore under what circumstances remediation liabilities may arise from “normal” operations. Second, we will discuss when such liabilities are “associated with the retirement of a long-lived asset.”

This two-step analysis of environmental conditions is supported by a statement in FAS 143 regarding environmental remediation liabilities.

B20. The Board also clarified the scope of this Statement relative to the scope of AICPA Statement of Position 96-1, Environmental Remediation Liabilities. This Statement applies to legal obligations associated with asset retirements. Legal obligations exist as a result of existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. SOP 96-1 applies to environmental remediation liabilities that relate to pollution arising from some past act, generally as a result of the provisions of Superfund, the corrective-action provisions of the Resource Conservation and Recovery Act of 1976, or analogous state and non-U.S. laws and regulations. *An environmental remediation liability that results from the normal operation of a long-lived asset and that is associated with the retirement of that asset shall be accounted for under the provisions of this Statement.* An environmental remediation liability that results from other than the normal operation of a long-lived asset probably falls within the scope of SOP 96-1. (Emphasis added.)

“Normal Operations”

FAS 143 provides the following guidance on “normal operations”:

A11. Whether an obligation results from the acquisition, construction, or development of a long-lived asset should, in most circumstances, be clear. For example, if an entity acquires a landfill that is already in operation, an obligation to perform capping, closure, and post-closure activities results from the acquisition and assumption of obligations related to past normal operations of the landfill. Additional obligations will be incurred as a result of future operations of the landfill.

A12. Whether an obligation results from the normal operation of a long-lived asset may require judgment. Obligations that result from the normal operation of an asset should be predictable and likely of occurring. For example, consider a company that owns and operates a nuclear power plant. That company has a legal obligation to perform decontamination activities when the plant ceases operations. Contamination, which gives rise to the obligation, is predictable and likely of occurring and is unavoidable as a result of operating the plant. Therefore, the obligation to perform decontamination activities at that plant results from the normal operation of the plant.

A13. An environmental remediation liability that results from the improper operation of a long-lived asset does not fall within the scope of this Statement. Obligations resulting from improper operations do not represent costs that are an integral part of the tangible long-lived asset and therefore should not be accounted for as part of the cost basis of the asset. For example, a certain amount of spillage may be inherent in the normal operations of a fuel storage facility, but a catastrophic accident caused by noncompliance with a company’s safety procedures is not. The obligation to clean up after the catastrophic accident does not result from the normal operation of the facility and is not within the scope of this

Statement. An environmental remediation liability that results from the normal operation of a long-lived asset and that is associated with the retirement of that asset shall be accounted for under the provisions of this Statement.

The next question the panel will explore is whether the obligation arising from normal operations is associated with retirement of the asset in question. FAS 143 provides guidance on what is “associated with retirement,” as provided below. In making this determination, it is important to understand the definition of “retirement” stated in A6.

“Associated with Retirement”

This Statement applies to legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, or development and (or) the normal operation of a long-lived asset, except as explained in paragraph 17 for certain obligations of lessees. As used in this Statement, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. This Statement does not apply to obligations that arise solely from a plan to dispose of a long-lived asset as that phrase is used in paragraph 15 of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. An obligation that results from the improper operation of an asset also is not within the scope of this Statement but may be subject to the provisions of AICPA Statement of Position 96-1, Environmental Remediation Liabilities.

A6. In this Statement, the term retirement is defined as the other-than-temporary removal of a long-lived asset from service. As used in this Statement, that term encompasses sale, abandonment, or disposal in some other manner. However, it does not encompass the temporary idling of a long-lived asset. After an entity retires an asset, that asset is no longer under the control of that entity, no longer in existence, or no longer

capable of being used in the manner for which the asset was originally acquired, constructed, or developed. Activities necessary to prepare an asset for an alternative use are not associated with the retirement of the asset and are not within the scope of this Statement.

A7. Typically, settlement of an asset retirement obligation is not required until the associated asset is retired. However, certain circumstances may exist in which partial settlement of an asset retirement obligation is required or performed before the asset is fully retired. The fact that partial settlement of an obligation is required or performed prior to full retirement of an asset does not remove that obligation from the scope of this Statement.

A8. For example, consider an entity that owns and operates a landfill. Regulations require that that entity perform capping, closure, and post-closure activities. Capping activities involve covering the land with topsoil and planting vegetation. Closure activities include drainage, engineering, and demolition and must be performed prior to commencing the post-closure activities. Post-closure activities, the final retirement activities, include maintaining the landfill once final certification of closure has been received and monitoring the ground and surface water, gas emissions, and air quality. Closure and post-closure activities are performed after the entire landfill ceases receiving waste (that is, after the landfill is retired). However, capping activities are performed as sections of the landfill become full and are effectively retired. The fact that some of the capping activities are performed while the landfill continues to accept waste does not remove the obligation to perform those intermediate capping activities from the scope of this Statement.

Our Expert Panel

We have the good fortune of having experts from the accounting, legal and environmental consulting fields to help us evaluate how these terms relate to environmental contamination, such as soil and groundwater contamination, and how companies

should apply them in assessing their environmental disclosure obligations under FAS 143 and FIN 47. Here is our expert panel:

Accounting

Katie Pavlovsky: Ms. Kathryn Pavlovsky is a senior manager with Deloitte Financial Advisory Services LLP (Deloitte FAS) in Houston and serves as an environmental specialist to internal and external audit teams in the areas of assessing environmental liability disclosures and accruals with respect to probability and the reasonableness of the cost estimates. She has been heavily involved in consultative efforts assessing and/or developing the design of environmental controls in conjunction with Sarbanes-Oxley readiness requirements, the adequacy of testing programs, and evaluating EHS/Sustainability frameworks for the purpose of identifying performance and efficiency improvement opportunities.

Legal

C. Gregory Rogers, J.D., CPA: Mr. Rogers is president and founder of Advanced Environmental Dimensions, LLC, a management consulting and education firm specializing in environmental financial reporting and related business strategies. He is also “of counsel” with a Dallas law firm focusing on environmental legal matters, where he advises public and non-public companies on the purchase, sale, financing, and redevelopment of contaminated real estate. Mr. Rogers is on the editorial board for *Brownfield News* and is the author of “Financial Reporting of Environmental Liabilities and Risks after Sarbanes-Oxley (Wiley 2005).”

Doug Clark and Sarah Slack: Mr. Clark is a partner at Foley & Lardner LLP’s Madison, Wisconsin, office. He is a member of the Environmental Regulation and Energy Regulation Practices, and the Energy Industry Team. Mr. Clark’s practice includes providing environmental and regulatory counsel to large and small companies, public utilities, dam owners, trade associations, the state of Wisconsin and individuals.

Ms. Slack is an associate in Foley's Milwaukee office and a member of the firm's Environmental Regulation Practice Group.

Consulting

Kenneth S. Tramm: Dr. Tramm is a program manager with Shaw Environmental, Inc. He is a licensed professional geoscientist and certified hazardous materials manager, who has over 12 years of environmental experience in laboratory, manufacturing and consulting settings. Dr. Tramm has managed hundreds of environmental assessment projects concerning the identification of potential releases of hazardous substances and petroleum products across the country. He routinely makes presentations on site investigation techniques, defining remedial objectives and Brownfield redevelopment initiatives for putting impaired property back into commercially-viable uses. Dr. Tramm is the author of "Environmental Due Diligence: A Professional Handbook" to be released this summer—a timely release just prior to EPA's "All Appropriate Inquiries" rule that goes into effect in November 2006.

Steve Courcier: Mr. Courcier is the chief financial officer of Chicago-based GaiaTech. With 15 years in the environmental field, he has broad experience in gauging the financial reporting implications of environmental risks and has developed extensive knowledge of the regulations and trends governing transparency in making representations regarding such matters.

Understanding What Environmental Contamination May Arise from "Normal Operations," and, Therefore, May Require Reporting under FAS 143/FIN 47

Question: "Normal operations" are the type of activities that the FASB identified as being covered by FAS 143. Contamination caused by "improper" activities or "catastrophic" events is not covered, but might be covered by FAS 5/SOP 96-1. The term normal operations may have several dimensions: What happens most of the time? How have practices changed over time? How does one

know the type of activities that caused contamination when you only know that contamination could exist in soil or groundwater?

Let's start with the meaning of "normal operations" in FAS 143. I would ask each of our panelists to please comment on the terms "improper" and "catastrophic" and how you believe these terms can be distinguished from "normal," not just linguistically, but practically. What does each of you perceive this term to mean? What do you believe the FASB meant? How do we know?

Pavlovksy: Contamination arising out of "normal" operations may be characterized by its predictability, gradual nature (occurring over time), and the inability to mitigate or avoid such contamination. Because contamination arising out of normal operations is unavoidable or is expected to continue throughout the useful life of the asset, it generally does not require an immediate response. Rather, the contamination is mitigated upon retirement of the asset.

Contamination arising out of improper operations or a catastrophic release is generally unexpected, requires immediate response or reporting, could have been controlled or mitigated and is the result of failure in equipment, operations or non-compliance with company procedures or protocols.

The determination of whether contamination arises out of normal operations versus improper operations may require the use of a multi-disciplinary team including, but not limited to, attorneys, Environmental, Health and Safety (EHS) and operational technicians. Deloitte notes the additional references and examples in A12 and A13 in FAS 143.

Rogers: The intended meaning of these terms is more clear when considered in light of the background and purpose of FAS 143. In February 1994, Edison Electric Institute asked FASB to add a project to its agenda to address accounting for nuclear decommissioning and other similar costs. At the time, the utility industry was looking for a consistent way to include nuclear decommissioning costs in depreciation

rates or some other rate recovery mechanism. In other words, the utility industry wanted its electricity customers to pay in advance for the anticipated future costs of decommissioning power plants.

The result was FAS 143, issued in June 2001. Because existing practice concerning accounting for all obligations associated with the removal of long-lived assets was inconsistent, FAS 143 was written with the broader intent of covering all asset retirement obligations (ARO), not just nuclear decommissioning costs. The background and purpose of FAS 143, however, makes clear that the intended scope of the standard was limited to normal costs of doing business (*i.e.*, future removal costs that would be “likely of occurring,” “predictable” and practically “unavoidable” given the normal operations of a nuclear power plant). See Paragraph A 12, FAS 143. How could utility companies expect customers to pay in advance for costs arising from “improper” or unanticipated actions or events? Costs arising from improper operations and maintenance of a facility resulting in a catastrophic accident (*e.g.*, Three Mile Island) and wrongful acts (*e.g.*, violation of laws or tortuous conduct) had to be excluded from the scope of FAS 143.

With this background, it makes sense that “improper” and “catastrophic” events, which are not likely of occurring and are inherently unpredictable, should be excluded from FAS 143. By contrast, “normal” operations, which are presumably both likely of occurring and predictable, should be included within the scope of FAS 143.

Clark/Slack: FASB promulgated FAS 143 to fill a perceived gap in financial reporting requirements related to the retirement of assets. See FAS 143, B20. Thus, we think it is worthwhile to keep the FAS 5/SOP 96-1 reporting requirements in mind when interpreting the scope and applicability of FAS 143.

Normal means usual, routine, expected. Normal and improper have to be applied in context. What was proper 30 years ago may be improper today. And what is normal or proper in one state may not be proper in a second state.

Can normal operations be “improper”? Of course they can. A bank robber is acting normally when he robs a bank. In the environmental context, we’d suggest that “improper” operations are operations and activities, whether or not they are normal, that are unpermitted or which trigger regulatory reporting and/or remediation obligations.

Generally, we believe that a spill or release is not the consequence of “normal” operations if action is taken to stop the spill or release when discovered, or if the spill or release triggers regulatory reporting and/or remediation requirements. Distinctions between normal and improper will also vary, depending upon the jurisdiction in which operations are located.

Catastrophic needs no additional definition.

Tramm: I would define “improper” operations as those resulting from the use of a given system in a manner inconsistent with the original design. These types of operations will likely result in immediate regulatory action as identified and will commonly be subject to both administrative orders and legal requirements for the responsible parties. These might arise from both intentional and unintentional acts by the entity. I would define “catastrophic” events as unforeseen conditions that would result in an unpredictable failure or release (*e.g.*, storm event or industrial accidents). “Normal operations” should include those actions typically associated with the type of business undertaken at a site and the common/likely impact to the environment from these operations (*i.e.*, chemical releases from gas stations or dry cleaners). FAS 143 notes that “normal operations” would be those that are “predicable and likely of occurring” as a result of site operations. The FASB further offers that “a certain amount of spillage may be inherent in normal operations of a fuel storage facility” in A13 of FAS 143. Based on examples given in FAS 143, it seems that the FASB would consider the predictable and/or common releases associated with different site uses to be inherent in “normal operations.”

Courcier: “Improper” indicates something was violated. Be it company policy, the law or the utilization/management of assets for purposes other than their designed or intended purpose.

“Catastrophic” indicates a sudden, unexpected event that was significant in its impact.

“Normal” indicates it is, or was, consistent with common practices at that time. In this regard it is very important to note that “normal” activities as they relate to environmental matters have changed significantly over the past three decades and will continue to evolve. Some years ago, cattle dipping was a “normal” part of doing business. So were dumping wastes, releasing wastes to rivers and lakes, and various other practices we know in hindsight created significant environmental contamination.

FASB’s objective and purpose for creating FAS 143 and FIN 47 was to improve the transparency and consistency of GAAP financials so that reasonable investors can rely upon them. For example, if the purchaser of a property can buy it for \$2 million, but the appraised value is \$10 million and the difference is an environmental condition, what best reflects this transaction? Is it simply a \$2 million asset or should it be a \$10 Million asset with an \$8 million “Asset Retirement Obligation”? The net impact is the same, but would a reasonable investor view them as being the same?

What the FASB didn’t want to do was to create a favorable accounting treatment for businesses that are “violating” laws, policies, procedures, etc., so they limited the application of FAS 143 to conditions which arise from “normal” operations. It would clearly be inappropriate for a company to increase the value of its plant/property because they were caught illegally dumping wastes, willfully contaminated land or groundwater, etc... Equally, if a “catastrophic” event were to occur, the entity should be incurring the necessary accruals and resulting expense to clean up the condition and shouldn’t be allowed to increase the value of their plant in these situations.

Question: *How would you apply this meaning to actual operations? FAS 143 refers to fuel terminals and leaks from such terminals as well as landfills. The Exposure Draft for FIN 47 used an example of a refinery with contamination that was required to be remediated at the time of closing of the facility.*

A refinery was discussed as an example in the Exposure Draft. The footnote for this example stated that “[f]or purposes of the example, assume that the existing soil contamination occurred as a result of the normal operation of the refinery.” The refinery scenario was originally offered as an illustration of a facility that may have an indeterminate life, but was subsequently dropped as an example of such a facility. Releases from underground tanks, above ground tanks, dry cleaners, process units at a chemical plant or refinery, and pipelines between facilities and within a facility also come to mind. Please walk us through some of these examples, and let us know, assuming soil or groundwater contamination exists or may exist from one of these units, whether you think the contamination would result from the “normal operation” of that asset? If you believe it would depend on certain factors, please identify those factors.

Pavlovksy: Contamination to land caused by releases from underground or above ground storage tanks, depending on the facts and circumstances, may be subject to FIN 47. However, if the failure of equipment arises from improper use (*i.e.*, the lack of maintenance), then FIN 47 would not apply. Depending on the facts and circumstances, leaks caused by rust or age-related fatigue may arise out of improper use. If the release from the tank was expected to occur, the costs associated with removing the tank and cleaning up the contamination resulting from the leak would need to be considered under FAS 143 or FIN 47. Contamination to the equipment, the actual tank, that must be decontaminated prior to disposal or disposed of according to certain regulatory requirements may occur as a result of normal use and would be subject to FAS 143 or FIN 47.

Additionally, pipelines between and within facilities may be subject to the same classification. Contamination arising out of rusted pipelines or bursts in pipelines may be classified as improper use, whereas those leaks that are predictable or likely to occur and the contaminated pipeline itself would result from normal use of the pipeline.

Tramm: To address the issue of whether contamination arises from “normal operations,” persons with requisite expertise will need to be engaged. An expert reviewing specific operations for a given site would have two general ways to determine whether a release resulted from normal operations. The two approaches are to generalize by operation or to evaluate site-specific information. A balance of these two approaches will often be needed.

The generalization method allows one to evaluate the likelihood of a release for a given type of operation without specific information on the operational history, typically performed in Phase I Environmental Site Assessments. For dry cleaners, a 1999 survey conducted by the State Coalition for the Remediation of Drycleaners estimated that 75 percent of *active* dry cleaning establishments had “some level of contamination.” K. Cardamone, *Drycleaner Remediation Programs: An Overview and Case Studies*, NAT’L NETWORK FOR ENVTL. MGMT. STUD., Aug. 2001. The 1999 survey did not include the thousands of former dry cleaning facilities that were not regulated during their operation. A 2001 EPA-funded study identified the primary reasons for releases of dry cleaning solvent were direct machine discharge to the sanitary sewer and indirect “backdoor disposal” of waste fluids. R. Schmidt, R. De Zeeuw, L. Henning and D. Trippler, *State Programs to Clean Up Drycleaners*, STATE COALITION FOR REMEDIATION OF DRYCLEANERS, Nov. 1999. When we evaluate these operations during a Phase I, we also factor in the common practices with regard to disposal methods, chemical use, and types of equipment available at the time of operation. I would find it difficult to argue that a dry cleaner operating from the 1950s to current day did not have a likely release from “normal operation.”

The second method to evaluate the likelihood of a release for a given type of operation is to actually assess the current and historical operations at a site, again, typically by a Phase I. Under this approach, one would evaluate operational records, conduct a site visit, interview knowledgeable parties and review regulatory/historical sources. Many variables, such as years of operation, the regulatory requirements during that time, chemicals handled, housekeeping, and maintenance are used by environmental professionals

to determine whether a release likely occurred. Using this method one would conclude that operations like dry cleaning, gas stations, pesticide mixing areas, circuit board manufacturing, printing and petroleum product refining/transmission/storage have a significant likelihood of causing a release during normal operation that may require remediation.

Clark/Slack: Regulated underground storage tanks. We note that even if there is no soil or groundwater contamination associated with the tank, there is almost always an ARO associated with the legally required costs of removing the tank and, upon removal, looking for contamination. In other words, the removal and investigation costs should be reported as an ARO regardless of suspicions about contamination. If contamination is found during removal, then the costs of addressing the contamination need to be reported, and based on our understanding, it makes most sense that the costs of addressing contamination that is known to exist in reportable quantities or concentrations would be disclosed under FAS 5/SOP 96-1, not FAS 143.

Generally, we believe that a spill or release is not the consequence of “normal” operations, if action has to be taken to stop the spill or release when discovered as the result of a legal requirement.

Rogers: FAS 143 should apply to environmental remediation costs associated with the retirement of these types of facilities, if and to the extent such costs are a normal cost of doing business (*i.e.*, likely of occurring, predictable and practically unavoidable). There is substantial evidence to suggest that environmental contamination—typically resulting from small and recurrent releases—is predictably associated with the normal operations of these types of facilities. One might expect that if these industries had the ability to include such costs in a rate recovery mechanism similar to regulated utilities, they would argue that environmental contamination is an undesirable yet unavoidable outcome of their current and (or) historical business operations.

Courcier: These are just a few of the numerous businesses and activities where environmental contamination is predictable and unavoidable. The

handling of regulated chemicals necessary to operate these businesses carries inherent risks which frequently result in contamination from frequent use.

This is not only normal, it is expected by the very agency which regulates environmental matters. The Environmental Protection Agency's (EPA) certification protocol for Underground Storage Tanks (USTs) makes this clear.

The EPA's rules for UST release detection tests (40 C.F.R. Part 280 (Technical Standards and Corrective Action Requirements for Owners and Operators of Underground Storage Tanks)) require that the test not demonstrate that a UST leaks more than 0.1 gallons per hour or up to 150 gallons per month depending upon the method selected. This clearly establishes that a certain amount of leakage is considered normal, and, if the materials that are leaking are hazardous substances, then environmental contamination will occur.

***Question:** How about RCRA hazardous waste management units, solid waste management units or areas of concern? Do you believe any remedial obligations of contamination from such units would fall under the FAS 143 terms "normal," "improper" and "catastrophic"?*

Clark/Slack: If the release is a known and permitted release, such as might occur at a permitted and operating TSD facility, then we would consider the release to be the consequence of normal operations. If the release is unpermitted, and for example might be addressed by RCRA corrective action requirements, then we would consider that release to be a consequence of improper or, perhaps, catastrophic operations.

If there is no contamination, or if there are spills that do not trigger regulatory reporting and/or remediation obligations, then there are no legal remediation obligations that could require ARO accounting. If contamination is found at levels that trigger regulatory reporting and/or remediation obligations, then the legal obligation is immediate and reporting would likely be required under FAS 5 or SOP 96-1.

Rogers: RCRA closure and post-closure obligations are a normal cost of business for certain industries. Such costs are likely of occurring, predictable and practically unavoidable. Depending on the circumstances, RCRA corrective action costs could arise from "normal" operations or "improper" operations. There is nothing inherently "improper" about events or actions leading to RCRA corrective action obligations and such obligations do not require a demonstration of fault. The question is, given the nature of the business, are such obligations and costs likely of occurring, predictable and practically unavoidable?

Courcier: These are RCRA processes that are permitted by EPA. Since these permits require financial assurances that the entity can clean up the units and any resulting contamination they must be considered a "normal" part of this process. Though I assume it is possible to have a "catastrophic" event at some point in this process, I do not see how they could ever be considered "improper," since they are in compliance with EPA rules.

Tramm: I would anticipate the releases associated with RCRA waste management units and solid waste management units to be within "normal operations." These will typically have previous documentation that has been prepared for the regulating entity to demonstrate the appropriateness of the current remedy. These demonstrations will often contain cost estimates that can be used for accounting purposes. Other areas of concern should be judged on a case-by-case basis for applicability of FAS 143. For this example, I would consider the improper operation or catastrophic failure to be outside of FAS 143.

Pavlovsky: In my professional experience, obligations associated with RCRA hazardous waste management or solid waste management units may be subject to FAS 143. Generally, these units are subject to operating and closure permits, which are obtained when the facility has demonstrated that the units will be constructed and operated for the purpose of minimizing releases during active operations and closure of the units. The permits are for the purpose of managing the contamination, asserting an expectation of and the

inability to avoid contamination. While these units may have components that must be addressed prior to retirement, they generally do not require immediate clean up response, because the contamination that occurs is generally predictable, expected and will likely continue to occur in the normal course of operations.

***Question:** Often we suspect or have discovered contamination, and the people who may have caused it or know how it was caused are unknown or unavailable. There may be no test that can be conducted to determine the type of activity that caused the contamination. What do you do if you don't know how the release or potential release was caused?*

Tramm: If, during the course of assessment of a site operation, a release is identified that is associated with some undocumented past use, there are several questions that need to be evaluated. The first will likely be responsibility to address the contamination and document compliance with a regulating entity. The second will be the development of a site history through assessment and investigation (Phase I/ Phase II) that allows conjecture on the likely source as “normal” operations or not. Through the collection of site-specific data, a picture should emerge as to what could have contributed to the release. This said, there may be some limited scenarios in which no potential source can be identified, and it would be reasonable to assume the contamination is the result of improper actions since no known operations are related to the source. These may arise from rogue employees or unauthorized discharges by others to a site.

Courcier: Based on our experiences, an incident about which the cause is not known would be extremely rare. Environmental investigative sciences are intended to identify the source and cause of environmental conditions. I can only assume that the cause of contamination would be unknown when environmental investigations have not been undertaken.

In the absolute lack of any information to determine the source and cause of an environmental condition, the decision would seem to be one of accounting policy. Consistency is a cornerstone of financial reporting. It

could be misleading to record AROs on other sites with similar conditions and ignore a potential ARO at another site. It would appear hard to defend the argument that the one site's contamination is not the result of “normal” use when there is no documentation to defend this position. I think responsible corporations should err on the side of caution in such cases.

Pavlovksy: In my professional experience, Phase I Environmental Site Assessments, or other documents which describe site histories or previous operations, also serve to provide information that would enable a company to identify potential causes of releases. Additionally, technical assessments or Phase II Site Assessments (which may include sampling the soil so that the specific contaminant may be identified), or conducting technical studies that estimate the duration of contamination (determined by depth or migration of or deterioration caused by contamination) may assist in determining the likely causes of the contamination.

Reviewing this information in conjunction with industry comparisons, operational processes and other company-wide information, such as insurance underwriting applications or due diligence records, may enable a company to document reasonable assumptions regarding the “cause” or “contributor” of the contamination so that further determinations may be made as to the appropriate accounting guidance.

Clark/Slack: This question confuses the issue. Historic processes could have been “normal” and “proper” in the context of the times in which releases occurred, but if the contamination triggers contemporary regulatory reporting and/or remediation obligations, then a present, not a retirement, obligation exists, regardless of how the release occurred.

Rogers: Several factors might influence how a reporting entity would analyze this issue. For example:

- Would an environmental professional determine, based solely on knowing the current or past uses of the property, that contamination is likely to be present? If so, this would indicate that the contamination arose from normal operations.

- Is the reporting entity legally obligated to undertake emergency response actions? If so, this would suggest an unexpected release that would be outside of normal operations. Also, it would make little sense to capitalize cleanup costs that will be incurred within 90 days or so.
- Is government enforcement or litigation considered imminent? If so, this would indicate improper activity with respect to either the release itself or the failure of a responsible party to take appropriate response actions.
- Does the entity have the ability to defer settlement of the obligation? If so, this would be indicative of normal operations.
- Is it likely, predictable and practically unavoidable that the company will incur an economic sacrifice in connection with the sale, recycling or ultimate retirement of the contaminated asset? If so, this would suggest that the contamination is a normal cost of business.
- In the case of an asset acquisition, did the new owner's legal obligation arise under a strict liability environmental law that imposes liability upon current owners without regard to fault? In other words, did the legal obligation arise from acquisition of the asset rather than from the prior owner's operations? If so, the basis of liability likely is not the "improper" operation of the asset.

Question: *Do you believe that if a potential release is considered a "recognized environmental condition" that would or should color whether it would be considered to have arisen from a "normal operation"?*

Tramm: The ASTM definition of a recognized environmental condition (REC) may be the most analogous means to identify potential releases, but will not always be synonymous with a "normal operation." The Phase I process may find releases from improper and catastrophic events at certain types of sites (*i.e.*, failure of a tank farm from an industrial accident or fire). I would think that most operational facilities that have uses with likely releases (*e.g.*, gas stations and dry cleaners) will have both RECs and "normal operations."

Rogers: A "recognized environmental condition" can arise where the current or former property uses indicate a likely past release of hazardous substances or petroleum products. The fact that an environmental professional can determine that a past release is likely, based solely on knowing the current or past uses of the property, is strongly indicative that environmental contamination is likely to occur, predictable and practically unavoidable for certain types of business activities.

Clark/Slack: We don't think so. "Recognized environmental conditions" are "recognized" not because of how the condition was created, *i.e.*, normal and proper vs. abnormal and improper, but because of the existence of the recognized "condition." Recognized environmental conditions identified in a Phase I Environmental Site Assessment is not a list of AROs, although a recognized environmental condition could be an ARO if the condition does not need to be addressed until the associated asset is retired. Again, whether a recognized environmental condition is normal or improper is not as relevant as what type of obligation the condition may trigger: an immediate obligation (covered under FAS 5/SOP 96-1) or a retirement obligation (covered under FAS 143/FIN 47). See FAS 143, ¶ B20.

Pavlovsky: Please see my prior comments.

Courcier: No. I don't see how the two are related.

Questions: *Are there any statistical data or industry knowledge that would assist in the determination whether the source of environmental contamination arises from normal versus improper operations? In this vein, who makes the call? The company? A lawyer? An accountant? A technical person? Whose job is it to make this determination for the entity reporting under FAS 143/FIN 47?*

Pavlovsky: Industry specifics play a critical role in that companies within the same industry generally have "like" contamination resulting in "like" obligations for clean up. If member companies within an industry exhibit "like" contamination with similar frequencies and/or magnitudes of occurrence, it is possible the

contamination is predictable, unavoidable or integral to operations. Additionally, the remaining existence of the contamination suggests it may not require immediate response or it is expected to continue as a result of the use of the asset. The determination of contamination arising out of “normal operations” versus improper use should be defined by the entity reporting under FAS 143/FIN47. The entity reporting should have people with the appropriate competencies making this determination, which many times consist of a multi-functional, cross-disciplined team of attorneys, technicians, and finance and accounting experts.

Clark/Slack: All of the above. The company’s operations personnel are typically best situated to identify the company’s tangible long-lived assets. Legal counsel then determines what legal obligations are associated with the retirement of the assets. A technical or environmental specialist estimates the costs of the legal obligation. The accountant calculates the present value and if necessary, crunches the probability analysis numbers for the ARO. Finally, the entity’s financial auditors double check everything.

Rogers: In certain cases, statistical data on the company’s past experience and industry experience with similar assets will be highly relevant to the question of whether environmental contamination is likely of occurring, predictable and practically unavoidable, and, therefore, within the scope of FAS 143. Consider, for example, underground storage tanks (USTs). Environmental laws require the owner/operator to remove the UST upon termination of use. Thus, the cost to remove and decommission a UST is clearly a normal cost of doing business for retail fuel stations, but what about the costs to address environmental contamination caused by UST leaks and spills? Experience tells us that a high percentage of USTs leak regulated substances into the soil and groundwater resulting in significant cleanup costs. Although, in many cases, a leak is not confirmed until the UST is removed, this does not mean that releases from USTs are not predictable well in advance of their removal. EPA studies provide detailed statistical information on the percentage of USTs that leak. These leaks are not catastrophic events, but rather gradual releases over time. These studies show that

the percentage of leaking USTs varies depending on the date of installation, type of equipment and other factors. Environmental remediation costs associated with small and recurring leaks from USTs, therefore, can be estimated with statistical accuracy based on an analysis of a company’s installed asset base and publicly available studies. For a company with a large number of USTs, such costs are likely of occurring, predictable and practically unavoidable. Moreover, they can be reasonably estimated. The same analysis holds true for many other types of environmental remediation obligations.

Tramm: As noted earlier, many publicly available studies and/or experienced environmental professionals can provide a general interpretation of the likelihood that a release has occurred from a given site use. For example, the EPA Groundwater Task Force noted that releases from petroleum underground storage tanks are considered the “most common source of groundwater contamination.” *Member Program Descriptions*, ENVTL. PROTECTION AGENCY OFF. OF UNDERGROUND STORAGE TANKS—GROUNDWATER TASK FORCE, <http://gwtf.clu-in.org/programs/oust.cfm>, June 15, 2004. Further, some studies, like the 1996 Minnesota Department of Agriculture study on pesticides in crop production retail facilities, which identified elevated pesticide releases at 28 of the 30 sites tested (over 93 percent), can help in refining the likely areas of concern. *Results of 1996 Soil Sampling of Pesticides on Crop Production Retailer Facilities*, MINN. DEP’T OF AGRIC., Aug. 1997. Having said this, each site’s history will be unique to the operational time period in question and subject to the efforts to minimize the impact from “normal operation.”

Each reporting entity should engage experienced individuals who are familiar with the issues being evaluated (generalizations or site assessments). Many larger sites will require a team of legal, accounting and technical professionals to fully understand the site history and remaining environmental legal issues that would arise at the time of asset retirement.

Courcier: There is considerable information in the public domain about historical practices for every industry as it relates to environmental risks. In fact,

EPA has prepared sector Notebooks for a number of industries to assist environmental professionals in their efforts to identify environmental risks.

In most cases there are two items that must be evaluated: the cause of the contamination and the practices or event that led to this contamination. Based on that assumption, this is clearly a decision for a technical professional. In the event that an entity wishes to argue that they “improperly” or illegally created contamination, then an attorney may be needed to advise the party on the legal implications of taking this position.

Question: *What processes would you suggest clients go through in attempting to determine whether a release or potential release would arise from a “normal use” or not? What criteria would you apply?*

Pavlovksy: Clients should evaluate whether the contamination (1) was considered predictable or “likely to occur,” (2) requires an immediate response (either clean-up or reporting to regulatory authorities) and (3) may be mitigated or avoided.

“Root-cause” assessments or support for insurance recoveries may assist in documenting that the release was the result of faulty equipment or non-compliance with company procedures, which may provide evidence that the contamination was avoidable, whereas the existence of operating and closure permits, monitoring programs and disposal/regulatory reporting requirements may indicate that releases are expected.

The company’s evaluation team should consist of attorneys, who are assessing the reporting protocols to regulatory authorities and the clean up obligations; technicians, who are assessing whether the release was avoidable or the result of non-compliance; and finance and accounting personnel, who are translating the determinations into accounting entries and disclosure.

Rogers: Begin by asking whether environmental remediation costs are normal costs of doing business for the company. In other words, are such costs likely

of occurring, predictable, and practically unavoidable? When evaluating this question, consider the following factors:

1. Are environmental pollution conditions common for the company in question?
2. Are environmental pollution conditions common for other companies in the same industry?
3. Can environmental contamination—even if unconfirmed—be reasonably predicted based on statistical analysis of prior company and industry experience?
4. Are the costs associated with improper management (e.g., failure to comply with a company’s safety procedures), wrongful acts (e.g., intentional violation of environmental laws) or extraordinary events (i.e., a catastrophic natural disaster)?
5. Is the legal obligation personal in nature (e.g., based on improper or wrongful conduct) or is the obligation inextricably linked to an asset? For example, would a future buyer of the asset be legally responsible to settle the obligation?
6. Would it seem appropriate for a regulated entity to include such costs in a rate recovery mechanism?
7. Are other companies or industries accounting for similar pollution conditions under FAS 143?

Courcier: Standard environmental due diligence processes are consistent with these needs. A study of the history of the site, operations, industry activities, etc... combined with a knowledge of the cause of the condition would be appropriate. “Catastrophic” or sudden and accidental releases are generally well documented so in the absence of such information the entity merely needs to determine if “improper” or “normal” use created the contamination.

Clark/Slack: We note that, typically, a release or potential release will trigger immediate reporting and/or remediation obligations. Differentiating normal from improper will vary by state and facility. If the release is unpermitted and triggers regulatory reporting and/or remediation obligations, then it is an improper release.

If a release causes contamination that can legally be left unaddressed until retirement, then an ARO must be reported.

Tramm: I would begin the process by completing a modified Phase I/Phase II process on assets that have potential issues before being retired. This approach would provide a defensible level of effort concerning the evaluation of the current and historical site use. Modified forms of the Phase I/Phase II process could also provide for the inclusion and review of past monitoring and maintenance records to assess the potential for releases. The determination of “normal” use could then be made for the site use in total rather than just assuming a release occurred for a given type of operation.

***Question:** Is there any case law that would shed any light on this issue; that is, when an environmental release is the result of normal versus catastrophic activities? In particular, are the insurance cases construing “sudden and accidental” coverage of pollution conditions under older insurance policies relevant?*

Rogers: There is significant case law interpreting the scope of the so-called “pollution exclusion” contained in insurance policies. These cases have developed the concept of “traditional environmental contamination,” generally defined as the “gradual or repeated discharge of hazardous substances into the environment.” The upshot is that gradual or repeated discharges of hazardous substances into the environment are often deemed “normal” or “routine” in the context of insurance litigation. For more information, see American Bar Association, Section of Litigation, Committee on Insurance Coverage Litigation, March/April 2004 Newsletter.

Clark/Slack: Again, the question incorrectly presupposes the significance of the “normal” vs. “improper” distinctions. If there is a legal obligation to address the contamination that results from a release, whether or not the release was normal, improper, or catastrophic, then the liability must be presently reported. If the legal obligation does not occur until an asset is retired, then there may be an ARO reporting requirement. See FAS 143, ¶ B20.

Courcier: In general, I am aware that insurance carriers have determined that leaks from underground storage tanks are not “sudden and accidental,” and, therefore, are not covered under old General Liability (GL) policies. One concern that companies need to consider is the practice of insurance recovery. To recover claims for insurance coverage under old GL policies, the company must assert that the contamination essentially resulted from “normal” use. To make this claim privately and then publicly assert that these same conditions are not the result of “normal” use is clearly a potential problem.

Pavlovsky: Deloitte believes response to this question requires legal judgment.

***Question:** For those issues not covered by FAS 143/FIN 47, in what instances would FAS 5 or SOP 96-1 apply?*

Courcier: Environmental risks identified as part of this process that are not determined to be AROs should be evaluated under FAS 5/SOP96-1. It would appear that the identification of these risks would inherently meet the threshold of contingent liabilities and, therefore, need to be evaluated under those accounting rules.

Pavlovsky: Examples include contingent liabilities and/or environmental remediation where there is not yet a legal obligation arising out of “normal” use or where there is a legal obligation but the obligation arises out of “improper” use. There are other examples. Note, under FAS 5 or SOP 96-1, the uncertainty is factored into the timing of the recognition of the liability as opposed to the measurement. In addition, purchase accounting guidance may be applicable to “acquired” contaminated assets.

Rogers: Paragraph B20 of FAS 143 states that “An environmental remediation liability that results from other than the normal operation of a long-lived asset probably falls within the scope of SOP 96-1.” To illustrate, Paragraph A13 of FAS 143 states that the obligation to clean up after a catastrophic accident caused by noncompliance with a company’s safety procedures does not result from the normal operation of the facility and is not within the scope of FAS 143.

Other examples where environmental obligations should be accounted for under SOP 96-1 or FAS 5 would include:

1. Obligations that are now or likely soon will be the subject of government enforcement or private litigation to compel cleanup or recover environmental damages.
2. Obligations resulting from the mismanagement of the company's assets.
3. Obligations resulting from intentional violation of environmental laws.
4. Obligations resulting from injury to persons or the property of others.
5. Obligations unrelated to the abandonment, decommissioning, sale, or recycling of an owned or leased asset.

Note that following issuance of FAS 143, the SEC revised SAB 92 to recognize that environmental exit costs—site restoration costs, post-closure and monitoring costs, or other environmental costs incurred when a property or facility is sold, abandoned or ceases operations—should be accounted for under FAS 143 rather than FAS 5 and SOP 96-1.

Clark/Slack: FAS 5 and SOP 96-1 apply to typical environmental reporting and/or remediation obligations that are immediate, including most actions regulated under Superfund, RCRA corrective action or state equivalent programs. FAS 143/FIN 47 apply only to those legal obligations that need not be addressed until an asset's retirement.

Tramm: Mandated remedial actions by a regulating entity for a release not found to be a result of "normal" operation would likely still meet the thresholds in both FAS 5 and SOP 96-1.

Review of Our Experts' Discussion of Application of the Terms "Normal Operations"

It is clear from our expert discussion that the application of the terms "normal operations" under FAS 143 and FIN 47 may play a critical role in whether environmental contamination must be

evaluated and reported on company balance sheets. Most of the experts appear to agree that contamination that is predictable or likely to occur from operations or assets would generally be considered to arise from "normal operations."

In trying to sort this issue out, it is valuable to review the statements in FAS 143 regarding contamination and "normal operations." FAS 143 specifically identifies a release to the environment that would arise from normal operations: "a certain amount of spillage may be inherent in the normal operations of a fuel storage facility, but a catastrophic accident caused by noncompliance with a company's safety procedures is not." For fuel storage facilities, such as underground and above ground tanks, this statement suggests some spillage may be inherent in normal operations, as do the EPA studies cited by our experts.

One view emerged that the terms "normal operations" and "associated with retirement" should be considered together. The concept is that if a release must be reported and remediated immediately then the obligation is not associated with retirement. Under this view, the cause of the release would be an "improper," not a "normal" operation or activity. On the other hand, another view emerged that the issue of normal operations should be analyzed independently of whether any legal obligation to address the contamination is associated with retirement. The literal reading of FAS 143 appears to favor the latter view, and certainly it does not appear the standards would be misapplied by following a two-step versus a one-step approach.

One other point I think is worth making. A determination that a particular release resulted from improper operations or catastrophic events rather than normal operations may have legal implications beyond environmental disclosure. First, "improper" may suggest the activities, actions or omissions failed to meet the duty of care under a negligence standard, or could suggest the party or its employees engaged in willful misconduct. Our experts seem to agree that "improper" in the context of FAS 143/FIN 47 indicates something was violated, such as a company policy, a law or regulation, or that the asset used was

for purposes other than its designed or intended purpose. FAS 143 states that a catastrophic event “caused by noncompliance with a company’s safety procedures is not” inherent in normal operations. This statement would be consistent with the view that an improper action violates some norm, whether legal or corporate. Such a conclusion may create a greater risk for legal liability under tort law for example, if an off-site landowner’s drinking water well is contaminated from a source on a company’s property. Such a conclusion in certain other circumstances or fact scenarios (such as a knowing violation) may pose a risk of a potential criminal investigation or prosecution under environmental statutes.

The distinguishing issue here may be to what extent a release was caused by violation of a legal or policy norm. Clearly, the FASB did not believe all releases constituted a violation, based on the fuel storage example. One question is whether an unknown or unintended release might not have been caused by a regulatory violation. Some of our experts have made statements that suggest that a release of fuel from underground tanks that does not exceed the amount of a release allowed by EPA or state standards might not result in a regulatory violation at all. They appear to conclude such a release might be “normal.” On the other hand, releases caused by failure to install cathodic protection required by the same standards might be a regulatory violation. Such a release might be considered “improper.”

Beyond potential lawsuits and possible criminal implications, a catastrophic event may be covered under the older insurance policies with “sudden and accidental” pollution coverage. Again, the historical nature of operations and what would be considered “normal” or “improper” may be a key issue, as well as the category in which the entity places the cause of the release. Such a decision may affect the ability to recover under these older environmental and CGL insurance policies. However, current environmental policies may have other exclusions from coverage that may need to be considered.

Care must be taken in classifying the cause of environmental contamination because of the

implications beyond financial disclosure. A considered legal analysis would appear necessary to ensure the reporting entity evaluates these issues and makes an appropriate decision with respect to classification of the cause of environmental contamination.

***Question:** The second controversial and potentially ambiguous term that we are going to discuss is “Associated with Retirement.” It is fundamental to FAS 143 that the legal obligation at issue must be associated with the “retirement” of a long-lived asset. “Retirement,” as defined by the FASB, means sale, abandonment, recycling or disposal in some other manner.*

What type of environmental statutory or regulatory obligations do you believe are associated with retirement? First, let’s consider particular assets like USTs and above ground storage tanks (ASTs). Are there environmental legal obligations associated with these types of assets? What else would you perceive to be possible obligations associated with their retirement?

Pavlovsky: Deloitte believes that response to these questions should be provided by legal professionals.

Clark/Slack: When a regulated UST is no longer in use, it must be properly abandoned and closed under federal and state law. Closure generally means that the tank must be removed from the ground, and an investigation must be done to determine if any contamination has occurred. An ARO exists for the removal and investigation costs, and these costs can be presently calculated based on reasonable estimates of the life of the tank and the removal and investigation costs. We think that FASB has not been clear on whether the costs of addressing contamination that is first discovered during the asset retirement process would be added into a then-reportable ARO, or whether the remediation costs would be reportable under FAS 5/SOP 96-1. We think that it makes more sense to report those retirement-discovered liabilities under FAS 5/SOP 96-1.

Rogers: Typically, environmental obligations associated with retirement will involve cleanup,

disposal and restoration activities. Closure and post-closure obligations under RCRA and corresponding state environmental laws applicable to ASTs, USTs, and solid and hazardous waste management units are inherently associated with the retirement of these types of assets.

Other types of remediation obligations may require a state-by-state analysis. For example, Texas environmental regulations expressly defer settlement of RCRA corrective action requirements at operating chemical and petroleum manufacturing plants pending termination of active industrial operations. Other states may have similar regulations or informal policies.

Because recycling falls within the FAS 143 definition of “retirement,” environmental laws imposing cleanup obligations in connection with the reuse of contaminated assets may also be considered to be “associated with retirement.” Some state brownfield programs are actually called “land recycling programs.” Risk-based corrective action programs developed in many states specify acceptable levels of contamination for different types of future land use. Remediation obligations under these programs are associated with the intended future use of the property rather than the discovery of past releases. For both operating and non-operating properties, achievement of risk-based cleanup levels may be a legal prerequisite for the continued use, reuse or “recycling” of the asset. All real property, including the thousands of abandoned and mothballed sites across the United States, will eventually be recycled for a different use. The costs to clean up these properties to protective concentration levels established under risk-based corrective action programs must eventually be borne by someone—the current owner of the asset, a future owner of the asset, or a government entity. If an environmental law establishes cleanup standards based on the intended future use of contaminated real estate, there would appear to be a legal obligation associated with retirement within the meaning of FAS 143, *even if there was a pre-existing legal obligation triggered by the initial release or discovery of the contamination.*

Courcier: Yes, there are clear legal obligations associated with USTs in certain states. Illinois, for

example, requires that idled tanks be removed and cleaned up after a specific period of time. It is possible, if not likely, that for every known environmental condition there is a local regulation that establishes a legal obligation to address it. When you begin to evaluate AROs on a country by country, state by state, county by county, and city by city basis, you are likely to discover that a number of environmental conditions meet this standard in various locales.

Tramm: The regulatory/statutory obligation will often be subject to the nuances of the state or federal law having jurisdiction. In New Jersey and Connecticut, for example, remedial responses are often integral to the retirement (*i.e.*, sale or “retirement”) of a property, while most other states wait for environmental due diligence efforts or other site activities to bring a release to their attention. With the UST example, if it is an operational facility, there are financial assurances currently being used by the regulating entity to evaluate the ability of the owner/operator to address ongoing and anticipated closure requirements. This provides us with a minimal cost framework to start from.

There may also be other obligations outside the direct regulatory/statutory requirements, such as when the retiring entity has a reason to suspect environmental impairment. As an example, if we were to discuss a UST facility that was not in operation during or later than 1974, it would likely not be registered (regulated) unless the USTs were removed or investigated for other reasons. Depending on operational history, we may still anticipate a release requiring remedial action upon retirement.

Question: *What types of statutory or regulatory requirements, if any, would be excluded? Explain why you believe they would not fit under FAS 143 or FIN 47?*

Rogers: Passive remediation laws like CERCLA grant broad legal rights to government agencies to ensure the cleanup of contaminated sites, but impose no affirmative legal obligations on a responsible person to incur cleanup costs in the absence of a government order or legal claim for cost recovery. FAS 143 does not appear to encompass contingent liabilities for asserted or unasserted claims under CERCLA or

similar laws, because such laws, in and of themselves, impose no legal obligation on a company to perform environmental remediation. Environmental cleanup obligations triggered by the release of hazardous substances to the environment or the discovery of a historical release would also seem to fall outside the scope of FAS 143.

Clark/Slack: Generally, we don't think that FAS 143 applies to situations where an entity is required to address contamination of an asset because of reporting and/or remedial action threshold exceedences under CERCLA, RCRA corrective actions, or state law equivalents. In other words, if the cleanup is not related to the retirement of the asset, but instead is triggered by the discovery of the contamination, then we think it makes more sense to report the liability under FAS 5/SOP 96-1.

Courcier: It is clear that SOP 96-1 applies to CERCLA claims. Additionally, it seems clear that any third party claim is outside the scope of FAS 143/FIN 47.

***Question:** Certain states, such as New Jersey, require that contamination be identified and remediated as part of the transfer of an asset. How does this affect your view of whether the legal obligation to remediate soil or groundwater contamination are AROs or CAROs?*

Clark/Slack: Laws requiring investigation and remediation of contamination prior to property transfer do give rise to an ARO. The ARO will be the costs associated with performing the required environmental investigation. Remediation costs would likely be unknown, and inestimable, until contamination is identified and quantified. Once the testing identifies any contaminant levels that trigger reporting and/or remediation obligations, then the entity would have an immediate obligation for which disclosure under FAS 5 and SOP 96-1 is likely required.

Rogers: If a state law requires environmental remediation in connection with the "sale" of a contaminated property, there is a legal obligation associated with retirement within the meaning of

FAS 143. This example shows why it is necessary to analyze each situation on a case-by-case basis, taking into account applicable state law.

Courcier: Are corporations actually going to make this evaluation on a state by state basis and is this appropriate? What has to be kept in mind is that the ultimate outcome of this exercise is to produce financials that reasonable investors can rely upon. Is it reasonable to record environmental conditions as an ARO for a property located in the state of New Jersey and not for a comparable site a few miles away across the border in another state? Would an investor actually ignore an environmental condition in a state other than New Jersey? I think the reality is that known and suspected environmental conditions impact investment decisions regardless of the location of those issues and this fact must be incorporated into accounting policy decisions.

Tramm: The requirement to identify the release and estimate the costs to address the release is more transparent in states like New Jersey and Connecticut, where progressive laws require the assessment of certain types of property. Beyond these specific requirements to identify and remediate environmental contamination at retirement, other states may permit a governmental entity to require remediation at retirement when due diligence by a buyer or lender reveals contamination. FAS 143 states that "uncertainty about the performance of conditional obligations shall not prevent the determination of a reasonable estimate of fair value." Thus, some level of investigation may be required as a result of retirement, at least in terms of the sale of an asset.

***Question:** What about contracts, such as leases or purchase and sale agreements? How do these come into play?*

Rogers: A lease provision obligating a lessee to remediate contamination of the leased premises upon termination of the lease is within the scope of FAS 143. If the owner of a contaminated property has a contractual obligation to a tenant, former owner, lender, or other party to perform remediation activities, this may be considered a legal obligation associated

with the “recycling” of the asset within the scope of FAS 143.

Clark/Slack: A contractual obligation to return a property to the pre-lease condition at the end of a lease agreement results in an ARO for the costs for fulfilling this obligation. For example, under a lease of land for the excavation of minerals, a clause which requires that the land be returned to the pre-contractual state would create an ARO. That ARO could require remediation of contamination to return the property to its pre-contractual state. If so, and if those costs can be reasonably estimated, then the ARO would include remediation costs. On the other hand, once again, if addressing the contamination cannot be legally postponed until retirement, then an ARO likely does not exist.

Courcier: A prudent investor will require environmental diligence in the acquisition of any business. Frequently, these efforts identify known or potential environmental impacts, and these conditions can result in price reductions, indemnifications, escrow arrangements and other financial instruments to transfer these risks. The documentation created in this process and the agreements which are reached would appear to create a clear need to record an ARO. For leases, an ARO can only be established if the contract requires the tenant to incur costs—generally to restore the site—at termination of the lease. Although this is fairly uncommon, we have encountered it in the United States and Europe.

Pavlovsky: Contracts must be considered when applying FAS 143 and FIN 47, because many agreements impose an asset retirement obligation. Also, keep in mind that although a contract may not impose a legal obligation, a company’s past practice may, but does not necessarily, create a legal obligation. Expectations that may create a legal obligation are based on the principle of promissory estoppel. Obligations that a party is required to settle as a result of existing or enacted written or oral contracts or by legal construction under the doctrine of promissory estoppel should be considered for compliance with FAS 143/FIN 47.

Question: Overall, to what extent do you believe the FAS 143/FIN 47 accounting standards will cover environmental contamination in the context of “retirement” associated with a long-lived asset?

Clark/Slack: FAS 143 and FIN 47 will cover the cost of the legal obligation associated with the retirement of a long-lived tangible asset. But because most environmental reporting and/or remediation legal obligations do not arise in the context of retirement of an asset, but rather from an immediate legal obligation to remediate, they would more likely be covered by the disclosure requirements in FAS 5 and SOP 96-1, not by FAS 143 and FIN 47.

Rogers: Each situation will require a case-by-case factual and legal analysis. In my judgment, however, eventually (and this may take years or even decades) reporting entities and their independent auditors will conclude that most environmental remediation obligations fall within the scope of FAS 143. Remediation obligations for owned and leased properties accounted for under FAS 5 and SOP 96-1 will be limited to those exceptional cases where:

1. Obligations that are now or likely soon will be the subject of government enforcement or private litigation (at least to the extent that the legal action seeks to compel cleanup or recover environmental damages as opposed to compelling a legally required cleanup).
2. Obligations resulting from the mismanagement of the company’s assets.
3. Obligations resulting from intentional violation of environmental laws.
4. Obligations resulting from injury to persons or the property of others.
5. Obligations unrelated to the abandonment, decommissioning, sale, or recycling of an owned or leased asset.

Courcier: I believe industry has grossly underestimated the impact of this reporting requirement and the FASB may not have realized how broadly this rule could be applied. By definition, retirement includes “sale,” and investors who are buying businesses view these environmental risks in a

completely different manner than the reporting entities currently do. Combine this with the continued movement by the FASB towards “fair value” and “principle-based” accounting rules, and it seems inevitable that corporations will be required to report numerous environmental conditions that are not currently being reported.

Tramm: I believe that in light of FAS 143 and the clarifications provided in FIN 47, entities trying to make good faith efforts to estimate retirement obligations for long-lived assets will begin to include an honest look at environmental impact. While for some time many facilities may have been sheltered under the “don’t ask, don’t tell” approach to identifying environmental impact, I think these new accounting standards may at least give the evaluation of environmental matters a more prominent place in the evaluation of the costs and benefits of a particular facility’s operations, to the extent any resulting contamination leads to a financial disclosure.

Review of Our Experts’ Discussion of the Term “Associated with Retirement”

The question as to the meaning of “associated with retirement” engendered interesting discussion. The analysis is clearly a legal one. As a result, our accountant deferred to legal counsel, and, thus, our lawyers provided the most relevant discussion. There was a slight divergence of opinion between our legal experts with respect to whether environmental contamination could constitute a legal obligation “associated with retirement.” One view is that most environmental contamination legally cannot be put off until asset retirement, so remediation liability should be classified under FAS 5/SOP 96-1, *not* FAS 143/FIN 47. Under this approach, removal and investigation of, for example, underground storage tanks would fall under FAS 143/FIN 47, but any environmental remedial obligations would fall under FAS 5/SOP 96-1.

The other view is that the classification of environmental cleanup obligations is not a black and white issue, but requires careful legal analysis, often on a state-by-state basis. This view holds that if, as a result of the regulatory framework or the exercise of

agency enforcement discretion, remediation can be or will be put off until sale, recycling or permanent removal from service, the obligation may be classified under FAS 143/FIN 47. An example may be contaminated soil under a building that an agency allows to remain in place until the building is demolished because of the structural threat to the building if soil were removed. Another example would be where state regulatory programs permit contamination to be managed in place until closure of the operation or facility. In such instances, even though there may be at first blush a more immediate obligation to conduct remediation, the obligation actually does not arise *until* retirement.

Careful legal analysis and judgment is required to address these issues. As a result, companies reviewing such issues should take care in evaluating the triggering event of any legal obligation as it could determine the extent to which FAS 143 and FIN 47 apply at all.

General Conclusions

Our experts have provided tremendous insight into how we should interpret and apply some of the most important terms and requirements of FAS 143 itself, and as interpreted by FIN 47. Since FAS 143 was issued by the FASB, the understanding and application of the standard has been mixed. The FASB concluded that its standard was not being properly applied and felt compelled to issue FIN 47 to clarify the meaning and scope of the original standard. Some period of time is required for any new standard, rule or law to be interpreted, understood and applied. It remains to be seen whether the passage of time will create clarity and uniformity. For now, we thank our panel of experts for contributing to a better understanding of these issues and in particular for providing guidance on the application and interpretation of critical terms.

Members of our panel agree that FAS 143/FIN 47 obligations should be addressed by identifying and evaluating environmental conditions, followed by structured analysis to determine which conditions are asset retirement obligations and which conditions are environmental loss contingencies.



Developing an inventory of owned and leased assets along with their associated environmental conditions, such as underground storage tanks, above ground tanks, pipelines, solid waste and RCRA units, and perhaps certain types of process units, seems to be a good place to start. The candidate items should then be put through a double filter, if you will, for FAS 143/FIN 47 purposes: first, they will fall either within the “normal” or “catastrophic/improper” classification. The ones that fall into the “normal” basket would be further reviewed under FAS 143/FIN 47 criteria. The ones that fall under the “catastrophic/improper” category would be further evaluated under FAS 5 and SOP 96-1.

A second screening of the issues that fall within the “normal” basket would then apply. Our panelists agree that legal counsel should evaluate whether any obligations apply to the unit or facility, particularly any remedial obligation, and, whether such obligations are “associated with asset retirement.” (Disagreement did arise whether this was a one or two-step process.) The attorney must consider not only regulatory and statutory obligations, but those that may arise from contracts or promissory estoppel. Generally speaking, if settlement of the obligation is directly triggered by or may be delayed until retirement, FAS 143/FIN 47 would apply, whereas, if immediate reporting and remediation are called for, FAS 5 and SOP 96-1 would apply.

Our experts agree that three disciplines are necessary to determine what should be reported under financial accounting standards and, to the extent applicable, SEC regulations: technical experts, lawyers with expertise in environmental and financial disclosure issues, and accountants with an understanding of these financial standards. The conclusion they appear to have reached is that a team with these requisite areas of expertise should be called upon to carry out the appropriate review of these matters through a well-defined, structured process.

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PUBLICLY AVAILABLE DATABASES AID FIN 47 REPORTING

Jon Walker

The new accounting obligations issued by the Financial Accounting Standards Board (FASB) in the form of FAS 143 and the interpretation of that standard through FIN 47 have imposed a duty on companies that have Asset Retirement Obligations (AROs) or Conditional Asset Retirement Obligations (CAROs) to develop a process to identify and recognize such obligations. Identifying potential AROs and CAROs can be a significant undertaking for some companies. For those companies with multiple subsidiaries or affiliates and numerous facilities, the process can be particularly challenging.

Many corporations have utilized publicly available databases to assist them through the first, and potentially most challenging, step—the identification and inventory of asset retirement obligations that may need to be accounted for on their financial statements. Some companies have searched for environmental records detailing the locations and quantities of these potential AROs and CAROs, such as underground and above ground storage tanks, spills, landfills, and other hazardous and solid waste management units.

Once these companies aggregate publicly available data on potential AROs and CAROs, they then typically attempt to corroborate the public data with environmental information maintained internally. Examples of the types of internal information companies have used to attempt to identify potential AROs and CAROs are findings of Recognized Environmental Conditions (REC) within previously-conducted Phase I Environmental Site Assessment reports on the company’s commercial real estate properties, internal facility surveys and internal asset management information systems.

The Use of Public Databases in Identifying Potential AROs and CAROs under FIN 47

There are myriad publicly-available databases with which companies can cross-reference their own internal environmental data. A wide range of databases

can be used to assist companies in quickly and efficiently searching government records relating to their properties at the federal, state, local, and even tribal levels in search of potential AROs and CAROs. In addition, proprietary databases, such as a historical dry cleaner and gas station database, may be used to support FIN 47 processes. Traditionally, these datasets have been used by environmental consultants in support of Phase I environmental site assessments to identify the potential presence of any hazardous substances or petroleum products on a property prior to a commercial real estate transaction. The same databases can support the process of complying with the new accounting standards.

Examples of the types of potential AROs and CAROs that companies have sought to identify using public databases include: underground storage tanks, historical spills, the presence of RCRA-permitted hazardous waste management units, solid waste management units or other reported environmental conditions at the company’s facilities.

Typically in the context of Performing Phase I Environmental Site Assessments (ESAs), property locations are used to identify potential environmental issues in the public databases. The use of company names, aliases, subsidiaries, affiliates or prior names provides information that may not be discovered if only a list of properties is searched in the databases.

Some of the companies that we have worked with that have used public databases to support financial reporting believe that corroborating internal data with publicly available data is not only a prudent practice for establishing a process for FIN 47 compliance, but also have concluded that it is an important step in meeting documentation or internal control requirements under the Sarbanes-Oxley Act. See Fig. 1 for an example of publicly available data supporting the review of potential AROs or CAROs.

Public Databases and ARO/CARO Identification: Two Examples

Underground storage tanks: Since closing, replacing or cleaning up spills from underground tanks may qualify as AROs or CAROs, any future costs

NAME	ADDRESS	CITY	STATE	DATABASES	UST	LUST	SPILL	TSDF	Landfill	PCB
ABC Corp.	123 Main Street	Walnut Ridge	AR	UST, TSDF	X			X		
ABC Corp.	200 Oak Drive	Anahein	CA	SPILL, PCB			X			X
ABC Corp.	500 Walnut Drive	Huntington Beach	CA	UST, LUST	X	X				
ABC Corp.	10 Access Road	Tampa	FL	SPILL			X			
ABC Corp.	52 Spandler Highway	Sylvania	GA	TSDF				X		
ABC Corp.	400 Service Road	Honolulu	HI	UST, Landfill	X				X	

Fig. 1: Corporate Environmental Report Snapshot

associated with USTs may need to be identified and reported under FIN 47. Several of our client companies have sought access to publicly available databases as a means of identifying all tanks within corporate owned or leased properties. In some cases, these companies own thousands of tanks in hundreds of locations, making the task of identifying them a significant effort. Performing what are fairly quick database searches upfront, however, may reduce what would otherwise be considerable identification costs.

According to a 2004 report from EPA's Office of Solid Waste and Emergency Response, the EPA estimates that 125,000 UST sites will require cleanup over the next 30 years. The study states that 60,000 to 120,000 UST sites may have future releases over a ten-year period. EPA estimates that UST cleanup costs could reach approximately \$16 billion, with an average cleanup of \$125,000 per site. Based on EPA's estimates, potential environmental liabilities for those companies that own large numbers of USTs may be significant.

Hazardous waste management units: Under the Resource Conservation and Recovery Act (RCRA), hazardous waste management facilities must provide assurances that they have sufficient financial assets to cover closure costs, post-closure maintenance costs, and third-party liability insurance coverage for accidental contamination. Estimates must be updated annually to account for facility expansion and inflation.

These agreed-upon costs of future financial obligations are reliable ARO data points. Based on publicly

available data, some companies may have over \$100 million in financial assurance at a single location. In the past, these obligations may not have been subject to disclosure. With the advent of FIN 47, however, these future obligations may need to be identified and accounted for. Solid waste disposal, transfer and treatment facilities carry financial assurance requirements and it may be necessary to track them in a similar manner.

According to the same EPA study referenced above, there are an estimated 3,800 regulated hazardous waste treatment, storage, and disposal facilities (TSDFs) that will eventually require remediation under the RCRA Corrective Action Program. According to the study, the cleanup of the estimated 3,800 sites is likely to cost approximately \$44.5 billion, or \$11.4 million per facility. Again, according to EPA's estimations, the costs associated with hazardous waste management units may be significant for certain companies.

Public Data's Role in FIN 47 Compliance and M&As

In addition to aiding FIN 47 accounting, commercially available environmental data may prove to be an important tool in mergers and acquisitions (M&A) research. During a typical M&A deal, environmental consultants are contracted to perform Phase I ESAs on the target company's properties using available government records. Over time, public environmental data may also be increasingly used by these consultants to help their corporate clients assess whether a

company's historical land use, spills and financial assurances match their ARO and other environmental financial disclosure. This can be a valuable tool in M&A negotiations. For instance, if public data indicates issues that should have been part of the company's financial disclosures, the purchase price may need to be re-evaluated, or post-closing purchase price adjustments might have to be made. To the extent environmental disclosure obligations increase, companies and their counsel and advisors may begin to use public environmental data more frequently as a means to check the financial disclosures made by target companies.

Some public corporations are feeling increased pressure to establish a process for reviewing potential environmental liabilities for the purposes of determining what issues must be identified and accounted for in their financial statements. The ability of a company to obtain environmental records that provide a review of publicly available databases presents a relatively quick and effective means of augmenting this process, and may be particularly helpful as a step in establishing an appropriate process for FIN 47 compliance.

Jon Walker is associate vice president of Business Development for Environmental Data Resources' Corporate division. He also co-chaired the ASTM E 1528 Task Group which published ASTM E 1528-06, Standard Practice for Limited Environmental Due Diligence: Transaction Screen Process.

COMMITTEE WEB SITE, LIST SERVE AND HOT TOPICS

The Special Committee on Environmental Disclosure's Web site provides both a place for "where to start your research" links and materials to update and explain the background and current developments in environmental disclosure responsibilities. We have the Primer, a modified and updated "PowerPoint" and a new Links page that provides a brief explanation of what to expect to find at each of the sources/sites listed. Please send us suggestions on additional sources for information on environmental disclosure responsibilities and for tracking this developing field. We will review them and merge them into the current structure. Similarly, suggestions on material which should be available on the site are greatly appreciated.

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Greg Rogers will identify issues and work with John Tatum to post hot topics on the Web site and notify committee members by the list serve. If you have any hot topic ideas, please contact Greg at rogers@guidaslavichflores.com.

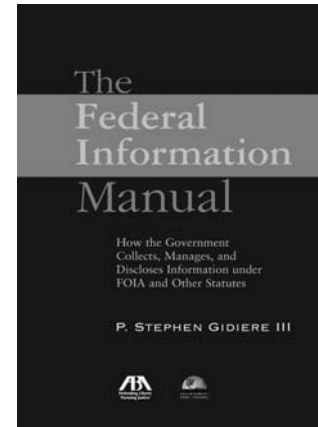
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